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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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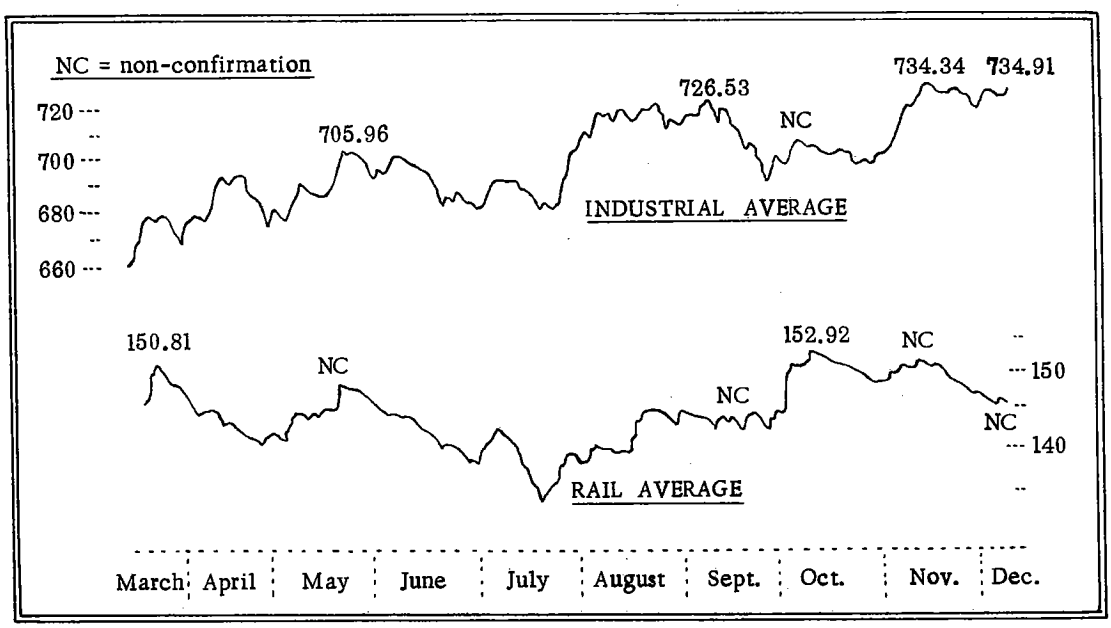
Registered with the Securities and Exchange Commission

December 15, 1961 Number 165



THE MARKET The price movements over the last seven months have been both complex and mystifying. On May 19, 1961, the Industrial Average recorded an all-time high of 705.96. Rails had established a peak of 150.81 two months earlier (in March), but by the time of the Industrial 705.96 peak, Rails had already sunk well below their own March high (see chart).

While Rails continued their downward progress (April through July), Industrials faltered but held relatively well. In July the Rail Average recorded a final low of 133.49, following which the two Averages rallied violently. By early September, Industrials had risen to another all-time high of 726.53, but Rails again faltered. A consolidation ensued which lasted into September.

Towards late September a new advance began, and this time Rails rose to a 1961 high of 152.92 (in October). To make matters more difficult, Industrials now refused to confirm the new Rail peak. Following the October Rail peak, we witnessed the most recent addition to our market puzzle. Rails embarked on a steady decline from their 152.92 peak while Industrials advanced in an almost vertical move to a third all-time high of 734.34 (November 15).

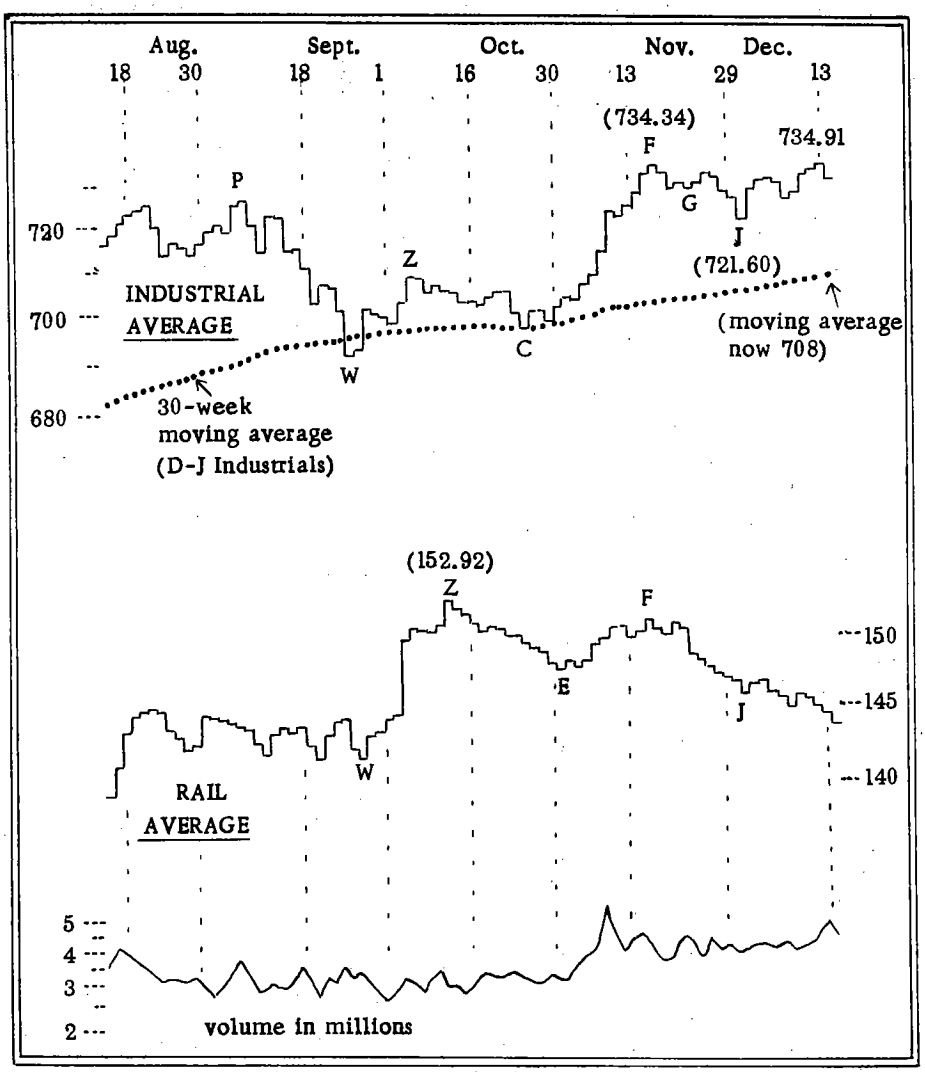
Thus, over the last seven months we have seen a steady series of "see-saw" movements with first one Average, then the other, rising to 1961 peaks. At no time since May have the two Averages risen to joint bull market highs; at no time since May have the Averages broken to new lows together.

To put the picture in its proper perspective, it is notable that although business has continued to improve and great things (economically) are predicted for 1962, the Industrial Average is now only 30 points (4%) above its May peak of seven months ago, while Rails are actually seven points under their March peak of nine months ago.

What does this long and complicated series of price swings mean? For one thing, when the two Averages are "out of gear" for a period as long as nine months, we can be sure that the market is reflecting a high degree of uncertainty. Because the Rails have provided most of the upside resistence, it might be said that the "uncertainty" has to do with the sales and transportation segment of the economy. Yet inventories have been building up, and manufacturers' sales and new orders in October climbed to the highest level on record. In the face of the evidence so far, the investor is forced to conclude that the market is attempting to appraise future developments which are not (at this writing) either clear or visible at all ("News known", wrote Hamilton, "is news discounted").

Those who have studied market history are aware of the fruitlessness of trying to pinpoint an area of possible or potential concern. Whether the hesitant performance of the market stems from the adverse balance of payments, the gold outflow, foreign competition or something else cannot be known at this time. Neither can we know whether the market is going to resolve itself in favor of the bulls or the bears. What we do know is that for over half a year the Averages have plotted a generally sideways pattern,

and such action bespeaks a market that "has something on its mind".



From the technician's viewpoint, only one question should be asked -- has the market been in the process of tracing a major base or a major top? The Dow Theory states that the last established trend is taken to continue until proved otherwise. Both the primary and secondary trends were last confirmed as bullish. So far, although the action of the Averages has been somewhat disappointing, there has been no definite evidence to indicate a reversal of the ascending structure which has been in effect since July, 1961. On declines (up to this writing), volume has not been forthcoming, and this has suggested an absence of liquidating sentiment. Moreover, odd-lotters have continued their selling operations for many months, a factor which ordinarily implies technical strength.

Taking the price pattern since July, belated confirmations have appeared on the rallies, while on declines Industrials have persistently refused to confirm the weakness of the Rails. The short-term picture could not be more confused, but this writer is of the opinion that until further evidence is at hand, the long-term argument must be weighted in favor of the bulls.

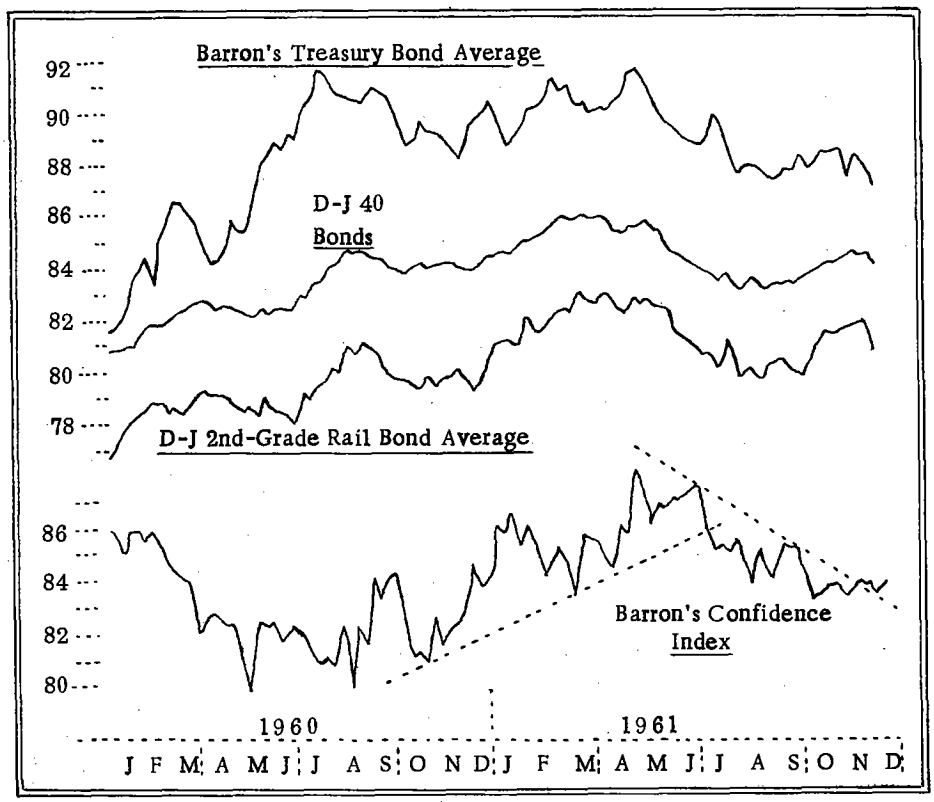
SHORT-TERM December 13 (Wednesday) saw an incredible performance wherein Industrials rose to a new all-time high of 734.91 while Rails broke to a low for the entire move since point Z. Any time the two average continually diverge to the accompaniment of high volume, Dow Theorists hold their breaths. Unless Rails reverse to the upside almost immediately, there promises to be trouble ahead. Presistent divergence in the two Averages is often followed by violent movements. If Industrials turn down and follow the declining path of the Rails, the danger signal would be a high volume violation of the G (721.60) level.

I drew attention to the poor showing of the new-high index in the last Letter. On December 13 the five-day average of new highs sank to 37 (against a peak of 97 on November 14). Such performances often precede a downturn in the advance-decline ratio; certainly the new-high index should have looked considerably stronger with the Industrial Average at an all-time high.

THE CONFIDENCE (C. I.) Letter 154 (August 24) was the last Letter to review the C. I. and the major bond indices. The following is from that Letter: "The theory behind the C. I. is simple enough. When bond buyers (a supposedly sophisticated group) turn bullish, they tend to forsake safety in favor of more attractive yields. Conversely, when bond buyers turn bearish, they tend to seek safety while foresaking yields. Barron's 10 Highest Grade Bonds represent a high degree of safety. The broad D-J 40 Bond Average represents a group with attractive yields. The C. I. is actually the ratio of the yield on Barron's 10 Highest Grade Bonds and the yield on the D-J 40 Bond Average. The C. I. rises when bond buyers turn bullish (when they move into the D-J 40 Bonds): the C. I. falls when bond buyers turn bearish (when they switch into Barron's 10 Highest Grade Bonds)."

Letter 154 noted that during the week of April 28, the C. I. recorded a 1961 peak of 88.5. Because of this, that Letter commented: "the outward limit of the C. I. prediction (four months later) would be the end of August. If the C. I. is to retain its usefulness as a forecasting tool, the market should see at least a temporary peak no later than August 28."

Two weeks after August 28 (on September 7), the market did hit a temporary peak of 726.53. From the high, Industrials broke 35 points to a September low of 734.34 on November 15 -- this despite the fact that the C.I. had never reversed its steady downtrend following the April 28 peak.

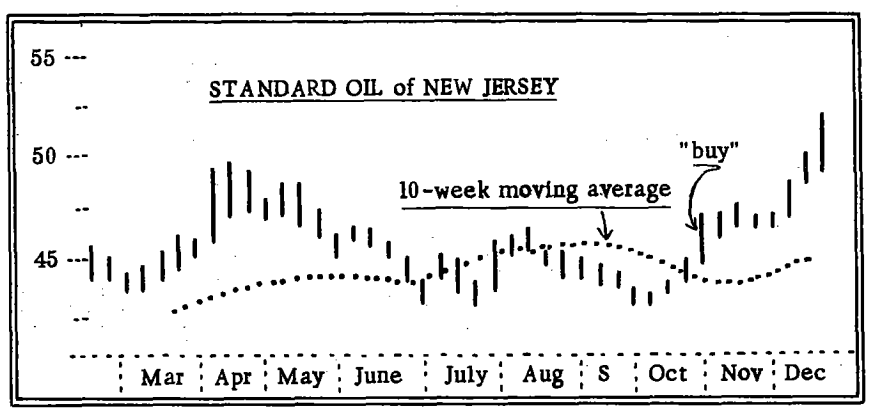


A current reading of the C.I. calls for a market decline which should have started no later than August 28 and should continue to two to four months beyond the recent C.I. low reading of 83.3 (established on October 6). This would put the bottom of a decline (and according to the C.I. we should now be in the decline) at around December 6 to February 6, 1962. First hint of an upward reversal in the C.I. came last week when the C.I. moved sideways through a descending trendline (see chart).

On a cold reading of the C.I., it is obvious that this indicator has been of little help in forcasting the direction of the market during the year 1961 (unless we stretch a point and argue that the declining C.I. negated the possibility of a booming market throughout the last three quarter of 1961). My own feelings regarding the C.I. can be best expressed in the old American expression, "Better luck next time".

Referring to the bond indices, an interesting commentary on the current situation is the fact that Barron's Treasury Bond Average is now at its lowest level of the past nineteen months. (On December 13 eighteen of the thirty listed Treasury Bonds had dropped to where they yielded over 4%). One reason for the bond weakness, of course, is the onus of the continuing gold outflow from this country. The steady drain on the nation's gold supply presents the constant possibility of a concerted Government move towards higher interest rates (to attract foreign funds to these shores). A hint in this direction was provided by the Federal Reserve in its recent announcement to the effect that as of January 1, commerical banks will be allowed to pay up to 4% on savings accounts. A second hint has been the hardening of yields on the "bellweather" 91 day Treasury Bills, now yielding over 2.5% (the high of their yield range for the last year).

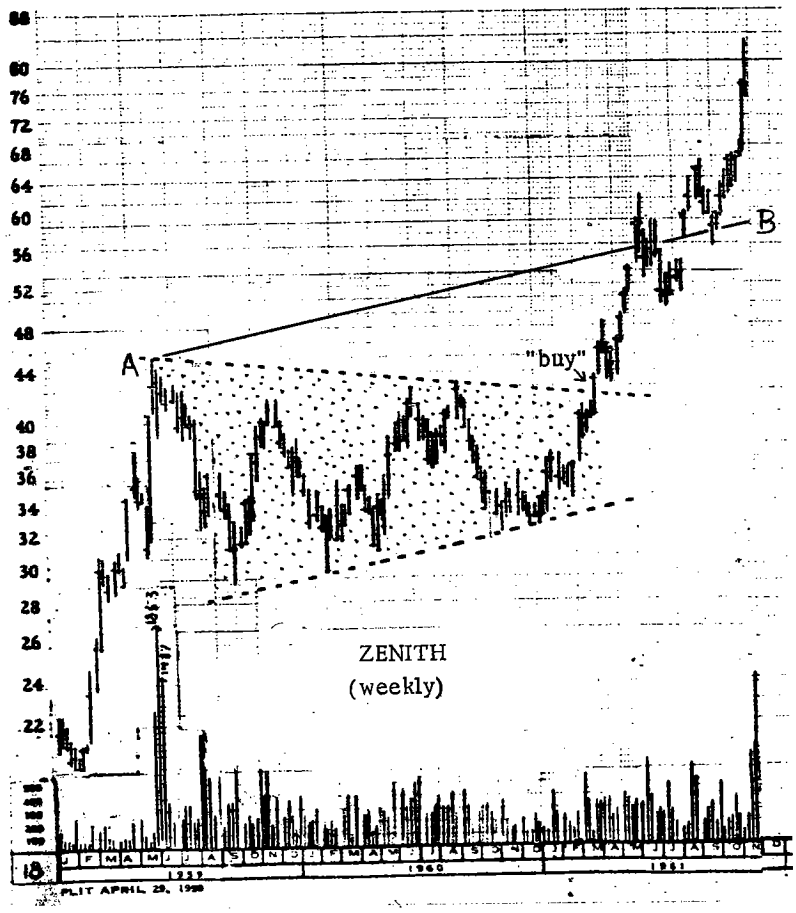
STOCKS Of 55 "key" stocks which are watched with particular care at this office, 33 are now above their 10-week moving average. This is an improvement of 5 since the last Letter (but still not indicative of anything like broad strength).



Standard of Jersey was placed in the "buy" catagory in Letter 161 on the basis of its breakout above the 10-week moving average (see chart). The breakout came at 46 3/4, and J has now risen to the 51-52 area to a high for the year. The stock is now seven points above its moving average (now 45 1/8), and traders might be willing to put "stop-loss"

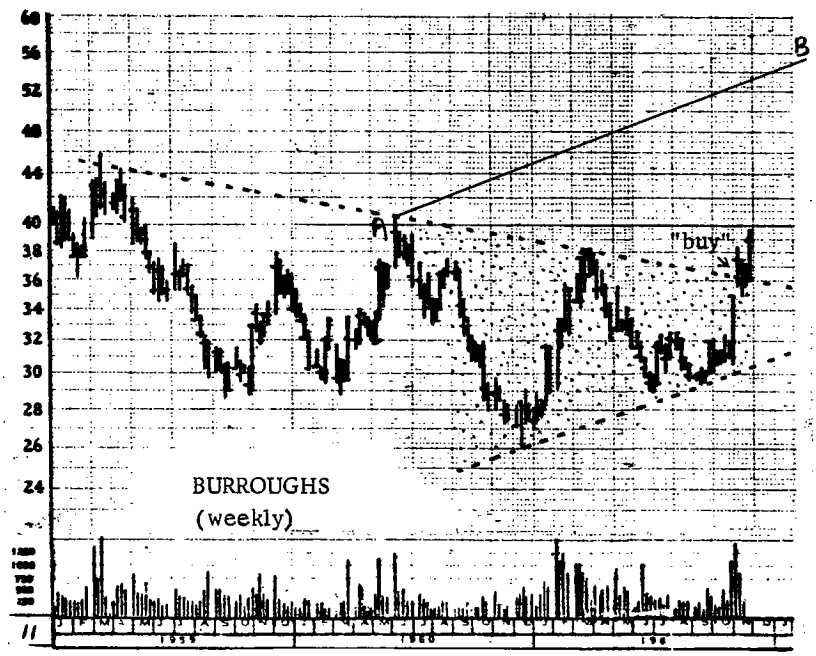
orders close to the stock because of the rapid rise (I, personally, would be willing to get stopped out at about 49 7/8).

STOCKS In Letter 137 I recommended Zenith as "a buy" on a breakout of the great triangle (dotted area on chart) which had formed during 1960 and 1961. Zenith was then 132 (comparable to 41 on the current split stock). The minimum upside measurement for Zenith was 56-60, or a rise to a trendline (A-B on chart) drawn parellel to the lower trendline of the original triangle. ZE has since more then doubled in price and has far surpassed the minimum upside expectations (a common occurrence in a bull market). Note that when ZE touched the line A-B, however, it faltered and a reconsolidation was necessary.



The important part of the lesson is this. Each bull or bear market seems to present particular chart patterns which hold special validity. Thus, in 1929, a common and extremely forceful "topping out" pattern was the "broadening formation". In 1949 a great many "rounding bottoms" were followed by unusual strength. Lately, I have noticed that some of the most important moves have come from unusually long and extended symmetrical triangles such as the Zenith pattern.

Letter 162 discussed the extended symmetrical triangle formation in Burroughs, and the stock was recommended as a buy at the market (then 36). The last Letter again drew attention to the excellent action in BGH and purchases were again recommended (at around 38).



While the odds are heavily against any stock being another Zenith, the minimum upside measurement (A-B trendline on chart) for BGH is about 53-56. Given a strong market, BGH might conceivable better its minimum upside expectation. At any rate, BGH has now appreciated 20% since its original recommendation in Letter 162 and continues to look strong.

LAST MINUTE NOTES To bring the chart on Page 1 up-to-date, December 13 saw another Industrial all-time high -- with Rails moving in the opposite direction. This flagrant (Rail) non-confirmation was followed next day by a drop of 3.97 points on Industrials and .82 on Rails. As has been the case all year, volume receded with lower prices. The critical nearby Industrial level is 721.60 (J on the page 2 chart).

(Written Thursday, December 14, 3:00P.M.)

Charts on this page courtesy of Traders Research, P.O. Box 6185, Lambert Airport, Mo.